No. 89-1149 (7)

In The

Supreme Court of the United States

October Term, 1990

COY R. GROGAN AND JOHN H. HENSON,

Petitioners,

v.

FRANK J. GARNER, JR.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

REPLY BRIEF FOR THE PETITIONERS

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ARGUMENT

I. THE COMMON LAW EXISTING AT THE TIME THE BANKRUPTCY CODE WAS ENACTED DOES NOT SUPPORT THE RESPONDENT'S CLAIM THAT CONGRESS INTENDED A "CLEAR AND CONVINCING" STANDARD OF PROOF UNDER § 523(a)(2).

Respondent argues that this Court must presume that Congress intended to maintain continuity with the "judicial practice" existing at the time of enactment of the Bankruptcy Code in 1978. From this assertion follows the

argument that Congress must have intended a clear and convincing standard of proof in the context of § 523(a)(2) because a "significant majority" of states required that fraud be proven by clear and convincing evidence.

Respondent's assertion that a "significant majority" of fraud cases required the clear and convincing standard in 1978 is incorrect. Respondent claims that cases from 34 states held that more than a preponderance of the evidence was required in civil fraud cases at common law when § 523(a)(2) was adopted. Respondent's Brief at 12 n. 6.

The authorities in five of the jurisdictions cited by respondent recite the familiar equitable maxim that a written instrument or legal relationship will not be set aside for fraud without clear or unequivocable proof.[1] Indeed, much of the confusion in this area stems from the chancery courts' imposition of a more demanding standard of proof in such cases where claims of fraud were unenforceable at law and the concern for fabrication of the fraud claim was high. As this Court has observed,

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[1] The authorities cited by respondent from Illinois, Minnesota, New Jersey, New Mexico and Oklahoma are grounded on the equity principle that fraud sufficient to set aside a presumptively valid written instrument or status conferred by law must be established by clear and convincing evidence. *Ray v. Winter*, 67 Ill. 2d 296, 367 N.E. 2d 678 (1977) (action to impose a constructive trust); *Weise v. Red Owl Stores, Inc.*, 286 Minn. 199, 175 N.W. 2d 184 (1970); *Bilowit v. Dolitsky*, 124 N.J. 101, 304 A.2d 774 (Super. 1973) (action to annul marriage based on fraud); *Rael v. Cisneros*, 82 N.M. 705, 487 P.2d 133 (1971) (quiet title action testing validity of deed); *Daubert v. Mosley*, 487 P.2d 353 (Okla. 1971) (action to set aside minor's release).

these kinds of cases "bear little relationship to modern lawsuits under the federal securities laws." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388 n. 27 (1983). The instant action involves the question of the non-dischargeability of a debt which arose from a money judgment obtained in an earlier lawsuit involving a claim of common law fraud in the sale of securities.

In four other jurisdictions relied upon by respondent, the cases cited actually hold that the proper standard of proof is the preponderance standard,[2] and two other jurisdictions cited by respondent recite the clear and convincing standard while deciding the case on other grounds.[3] In fact, the "significant majority" rule asserted by respondent was followed in less than half the states when the Bankruptcy Code was enacted in 1978. Thus, respondent's argument that § 523(a)(2) should be interpreted in light of the common law and the scheme of

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[2] The cases cited by respondent from Iowa, Kansas, South Carolina and Texas do not support the proposition that a heightened standard of proof applies in civil fraud actions. These cases hold expressly that the proper quantum of proof required in a civil fraud case is a preponderance of the evidence. *Hall v. Wright*, 261 Iowa 758, 156 N.W. 2d 661 (1968); *Fox v. Wilson*, 211 Kan. 563, 507 P.2d 252 (1973); *Gilbert v. Mid-South Machinery Co., Inc.*, 267 S.C. 211, 227 S.E. 2d 189 (1976); *Frankfurt v. Wilson*, 353 S.W. 2d 490 (Tex. Civ. App. 1961).

[3] The Michigan and Nebraska authorities cited by respondent recite in *dicta* the principle that fraud must be proven with clear and convincing evidence, but the decisions rest on other grounds. *Hi-Way Motor Co. v. International Harvester Co.*, 398 Mich. 330, 247 N.W. 2d 813 (1976) (fraud may not be based on promises of future action); *Page v. Andreasen*, 200 Neb. 641, 264 N.W. 2d 682 (1978) (appeal from grant of summary judgment for a defendant not a real party in interest).

jurisprudence existing at the time of the enactment does not support the argument that Congress intended to impose an extraordinary, higher standard of proof in nondischargeability proceedings in bankruptcy.

In addition, it is important to maintain the distinction between an adjudication of common law fraud which is determined by the fact-finder under the prevailing state standard of proof and the determination of nondischargeability which arises ordinarily after the existence of the fraud debt has been adjudicated. Section 523 of the Code provides a number of exceptions to the general discharge of debts arising ordinarily from bankruptcy. Respondent has offered no cogent reason why a creditor with an existing fraud judgment against a bankrupt debtor must prove that the debt is within the fraud exception to discharge with a quantum of evidence greater than required to obtain the fraud judgment in the first instance.

There is utility in determining nondischargeability with the same degree of assurance of reliability as required in the underlying proceeding to establish the debt. *In re Braen*, 900 F.2d 621, 625 (3d Cir. 1990). This utility may be achieved by adopting the preponderance standard in nondischargeability cases. In those instances where the preponderance rule applies in the underlying fraud case seeking monetary damages, the waste of judicial resources occasioned by a relitigation of the issues in bankruptcy court is avoided. *Cf. In re Braen*, 900 F.2d at 625. Where the underlying claim requires the heightened standard of proof of fraud, the debtor receives the benefit of that protection because there can be no "debt" to

discharge unless the greater standard of proof is met initially as the fraud claim is adjudicated.

II. THE FRESH START POLICY OF THE CODE DOES NOT WARRANT APPLICATION OF THE CLEAR AND CONVINCING STANDARD AND APPLICATION OF SUCH STANDARD WOULD IMPROPERLY PREFER THE DEBTOR'S INTERESTS OVER A DEFRAUDED CREDITOR'S INTERESTS.

A. THE DEBTOR'S INTEREST IN A FRESH START IS NOT SUFFICIENTLY IMPORTANT TO WARRANT APPLICATION OF THE CLEAR AND CONVINCING STANDARD.

The general rule in civil litigation is that the parties need only prove their case by a preponderance of the evidence. *See Price Waterhouse v. Hopkins*, ___ U.S. ___, 109 S. Ct. 1775, 1792 (1989). *See also Huddleston*, 459 U.S. at 390 (1983) ("the preponderance-of-the-evidence standard [is] generally applicable in civil actions"). Exceptions to this standard are uncommon, and in fact are ordinarily recognized only when the government seeks to take unusual coercive action – action more dramatic than entering an award of money damages or other conventional relief – against an individual. *Price Waterhouse*, 109 S. Ct. at 1792.

In this case respondent asks the Court to create an exception to the general rule that the preponderance of the evidence standard applies in civil cases. Respondent's justification for this exception is that a central purpose of the Bankruptcy Code is to afford a debtor a "fresh start". Respondent believes that the public and private interests

implicated by the debtor obtaining this fresh start (effectuated through the discharge provisions of Code § 727) transcend the interests involved in a typical civil case. Indeed, respondent claims that the debtor's interest in a fresh start, which is at stake during a nondischargeability proceeding, is of "crucial private and public importance."

Petitioners do not challenge the proposition that a "fresh start" is a central purpose of the Code. *See Lines v. Frederick*, 400 U.S. 18, 19 (1970). Nor do petitioners quarrel with the principle that the debtor has an important personal interest in obtaining a discharge. *See United States v. Kras*, 409 U.S. 434, 445 (1972). However, the present case does not concern whether respondent is generally entitled to a discharge; rather, the issue is simply whether petitioners have adequately proved the statutory exception to discharge embodied in Code § 523(a)(2). Reference to the "fresh start" policy underlying the Code provides no help in determining what Congress intended regarding standards of proof in a nondischargeability case. *See In re Braen*, 900 F.2d at 625. The observation that a finding of nondischargeability prevents the debtor from obtaining a fresh start "provides little assistance in construing a section expressly designed to make some debts nondischargeable". *United States v. Soleto*, 436 U.S. 268, 280 (1978).

Where Congress has not prescribed the appropriate standard of proof and the Constitution does not dictate a particular standard, the Court must prescribe one. *Huddleston*, 459 U.S. at 389. Clearly, Congress has not stated the appropriate standard of proof to be applied in a

nondischargeability proceeding. Thus, it must be determined whether a standard is dictated by the Constitution. It appears that respondent believes that his interest in a discharge is of sufficient importance to merit constitutional protection.

Respondent cites *Addington v. Texas*, 441 U.S. 418 (1979) in support of his proposition that "more is at stake in a section 523 proceeding than the general run of issues in civil cases where the preponderance standard is appropriate." Respondent's Brief at 26. *Addington* concerns the standard of proof required to commit a person to a state mental hospital. The Court found that the individual's interest in the outcome of a civil commitment proceeding is of such weight and gravity that due process requires "proof more substantial than a mere preponderance of the evidence." *See Addington*, 441 U.S. at 427. Noting that the highest standard of proof, proof beyond a reasonable doubt, was usually not appropriate except in criminal cases, the Court found that the intermediate standard of clear and convincing proof fairly balanced the rights of the individual and the interests of the state. *See Addington*, 441 U.S. at 431.

In *Addington* the Court cited other cases involving "particularly important individual interests" in which constitutional due process mandated application of the clear and convincing standard.[4] *See Addington*, 441 U.S.

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[4] The Court also observed that the clear and convincing standard is applied in civil fraud cases. However, as discussed in the preceding section of this brief and in petitioners' original brief on the merits (Petitioners' Brief at 16), such observation was merely dicta and contrary to the standard of proof actually applied in a majority of jurisdictions.

at 424, citing *Woodby v. INS*, 385 U.S. 276 (1966) (deportation); *Chaunt v. United States*, 364 U.S. 350 (1960) (denaturalization); and *Schneiderman v. United States*, 320 U.S. 118 (1943) (denaturalization). One could add to this list *Santosky v. Kramer*, 455 U.S. 745 (1982) (termination of parental rights); and *Cruzan v. Director, Missouri Department of Health*, ___ U.S. ___, 110 S. Ct. 2841 (1990) (withholding of nutrition and hydration from a person in a persistent vegetative state).

Addington, however, is completely inapposite to the present case because respondent's interests at stake in this case are qualitatively different (and constitutionally less important) than the individual interests considered in *Addington*. In *Addington* and each of the foregoing cases the interests involved were found to be "both 'particularly important' and 'more substantial than mere loss of money' ", *Cruzan*, 110 S. Ct. 2853, quoting *Santosky*, 455 U.S. at 756, and therefore, it was determined that protection of these interests by a heightened standard of proof was constitutionally required. These cases stand in sharp contrast to the present case which considers merely a debtor's interest in avoiding satisfaction of a fraud debt through a discharge in bankruptcy.

A discharge in bankruptcy is a privilege, which Congress may grant with conditions or withhold altogether. *See In re Lah*, 88 Bankr. 141, 145 (Bkrtcy. N.D. Ohio 1988); *In re Roedel*, 34 Bankr. 689, 694 (D. N.J. 1983). A discharge is a legislatively created benefit, not a constitutional one; there is no constitutional right to obtain a discharge of one's debts in bankruptcy. *See Kras*, 409 U.S. at 446.

In *Kras* the Court recognized that although the debtor's personal interests in obtaining a bankruptcy discharge were "important", such interests did not rise to the same constitutional level of "particularly important individual rights or interests" involved, for example, in obtaining a divorce:

> If Kras is not discharged in bankruptcy, his position will not be materially altered in any constitutional sense. Gaining or not gaining a discharge will effect no change with respect to basic necessities. We see no fundamental interest that is gained or lost depending on the availability of a discharge in bankruptcy. *Kras*, 409 U.S. at 445.

The Court went on to observe, "government's role with respect to the private commercial relationship is qualitatively and quantitatively different from its role in the establishment, enforcement, and dissolution of marriage." *Kras*, 409 U.S. at 445-446.

The Court could scarcely have been clearer that there is no constitutionally protected interest involved in obtaining a discharge. Instead, the issue of discharge simply involves a private commercial relationship between the debtor and a creditor. It would be inappropriate to "constitutionalize" what is simply a monetary dispute between private parties. *See, Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 761 n. 7 (1985) (attempted implication of First Amendment rights in a private libel dispute would "constitutionalize the entire law of libel.") Accordingly, because there is no constitutional protection afforded to the debtor's interest in a discharge, there is no basis for protecting this interest by a heightened standard of proof.

Lacking any congressional direction or constitutional mandate requiring application of the clear and convincing standard, the general rule of preponderance of the evidence applies. Such conclusion is consistent with *Huddleston* which holds that imposition of even severe civil sanctions which do not implicate particularly important individual interests is permitted upon proof by a preponderance. *See Huddleston*, 459 U.S. at 389-390.

Huddleston cites the following cases in which the consequences to the individual were quite severe, but because no constitutionally important rights were involved, the preponderance standard was found appropriate: *United States v. Regan*, 232 U.S. 37 (1914) (proof of acts exposing a party to criminal prosecution); *Steadman v. SEC*, 450 U.S. 91 (1981) (sanctions under the Investment Advisors Act, including permanently barring an individual from practicing his profession); and *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (establishment of fraud under § 17(a) of the Securities Act of 1933). *Huddleston* found that securities fraud under § 10(b) of the Securities Exchange Act of 1934 could be proved by a preponderance. Subsequent to *Huddleston*, the Court ruled that despite the "serious economic consequences" to the defendant, paternity could be established by a preponderance of the evidence. *See Rivera v. Minnich*, 483 U.S. 574 (1987).

Thus, although a ruling that respondent's debt to petitioners is nondischargeable may have serious economic effects on respondent, such consideration is not useful in selecting the appropriate burden of proof. *See Soleto*, 436 U.S. at 280. This case is, at its most fundamental level, simply a dispute over respondent's payment of a

debt. No constitutionally important interest is implicated in such a dispute, and accordingly, the preponderance standard is applicable.

B. APPLICATION OF THE CLEAR AND CONVINCING STANDARD IMPROPERLY PREFERS THE DEBTOR'S INTERESTS OVER THE CREDITOR'S INTERESTS.

The standard of proof serves to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision. *Addington*, 441 U.S. at 423. A preponderance-of-the-evidence standard allows both parties to share the risk of error in roughly equal fashion. Any other standard expresses a preference for one side's interests. *Huddleston*, 459 U.S. at 390. Adoption of a requirement that a creditor must prove exceptions to discharge by clear and convincing evidence would be an expression of a preference for the debtor's interest in a discharge over a defrauded creditor's interest in receiving compensation. Such a preference is not justified.

The discharge granted by the Code was intended to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes . . . [the bankruptcy act] gives the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). Congress recognized the importance of the fresh start by enacting the Code. *See Kras*, 409 U.S. at 445.

However, the present case does not involve an "honest but unfortunate debtor" who has suffered "business misfortunes". This is a case of a debtor whom a jury has found committed willful fraud with sufficient malice to warrant punitive damages. The solicitude of Congress stops at the debtor who does not measure up to the standard of an "honest but unfortunate debtor" and who has engaged in grossly irresponsible or fraudulent conduct. *See In re Howard*, 55 Bankr. 580, 583 (Bkrtcy. 1985), quoting Riesenfield, *Creditors' Remedies and Debtors' Protection* 729 (3d ed. 1979).

Congress was not required to enact any exceptions to discharge. *See generally Kras*, 409 U.S. at 447. By creating these exceptions Congress has clearly indicated that there is a strong policy against permitting certain debtors to avoid responsibility for their malicious conduct:

> Congress had reasons for enacting the exceptions to discharge. . . . While bankruptcy proceedings are intended to afford debtors a 'fresh start', the provision here expresses Congress' determination that debts incurred as the result of a debtor's willful and malicious injury of another are of a type that bankruptcy ought not to forgive. *Combs v. Richardson*, 838 F.2d 112, 116 (4th Cir. 1988).

See also In re Braen, 900 F.2d at 625 ("the nondischargeability exceptions reflect Congress' belief that debtors *do not* merit a fresh start to the extent that their debts fall within § 523").

Congress has created a statutory system which already tends to favor the debtor by requiring the creditor to bear the burden of proving the debt is not dischargeable, rather than the debtor proving the debt is

dischargeable. There is no basis, however, for finding that Congress determined that defrauded creditors were entitled to relief under Code § 523, and yet decided to decrease the likelihood that such relief would be granted by heightening the standard of proof. Instead, it is evident that Congress has determined there are competing policies involved in a nondischargeability case: the debtor's interest in a discharge and the defrauded creditor's right to compensation. In light of *Kras'* finding that a discharge in bankruptcy does not implicate a fundamental interest of the debtor, it appears clear that Congress did not find either interest to be more important or entitled to special protection. Where the interests at stake are equal, the appropriate standard of proof is that normally applied in private litigation, proof by a preponderance of the evidence. *See Rivera*, 483 U.S. at 581. A heightened standard of proof is not justified to prove a Code § 523 exception to discharge. *See Combs*, 838 F.2d at 116. Accordingly, in the present case, where the competing interests are equal, the Court of Appeals erred in requiring proof by clear and convincing evidence.

CONCLUSION

For the foregoing reasons, petitioners request that the judgment of the Court of Appeals be reversed and the case be remanded to the District Court for entry of judgment in petitioners' favor on the claims under § 523(a)(2) of the Bankruptcy Code.

Respectfully submitted,

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